No. 77-832

In the Supreme Court of the United States

OCTOBER TERM, 1978

BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM, PETITIONER

v.

FIRST LINCOLNWOOD CORPORATION

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SEVENTH CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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1. Respondent's principal argument is that approval of its application "would do no harm to anyone" and that "the decision below [therefore] is right" (Br. 8) in setting aside the Board's denial. Respondent misses, we think, the central point of our argument—that the Board's authority to deny applications that fail to make provision for adequate capitalization of the holding company and the proposed subsidiary bank is a safeguard against injury to the nation's banking system. The Board has consistently used its statutory authority to require applicants to establish financial responsibility, including the provision of capital to their subsidiaries (Pet. Br. 17 n.17). By so exercising that authority, the Board has helped to create a pool of capital that constitutes a vital margin of safety in the national banking system and provides protection against bank failures. If the Board may not with-

hold approval even when "the financial * * * resources * * * of the company or companies and the banks concerned" (12 U.S.C. 1842(c)) are seriously inadequate, it will be hindered in the performance of this important function.[1] It should not be necessary for the Board to find that the condition of an undercapitalized subsidiary would be caused or worsened as an immediate and necessary result of the formation of the holding company.[2]

2. Respondent argues, however, that "formation of a holding company is different from the formation of a

[1]Following the financial panic of 1907, Congress enacted the Federal Reserve Act of 1913, ch. 6, 38 Stat. 251. It recognized that prevention of future bank failures would depend on "a suitable banking capital as a margin of safety." S. Rep. No. 133, 63d Cong., 1st Sess. 7-8 (1913). In 1933 Congress enacted the Glass-Steagall Act, ch. 89, 48 Stat. 162, again stressing that bank failures could be prevented by "strengthening of the capital of banks" and "closer and stronger supervision." S. Rep. No. 584, 72d Cong., 1st Sess. 11 (1932). Section 19 of the Glass-Steagall Act required bank holding companies to provide reserves of "free assets" as a capital cushion for their subsidiaries and conferred supervisory authority on the Board. S. Rep. No. 584, *supra*, at 10; 48 Stat. 186-187. Section 19 is the progenitor of 12 U.S.C. 1842(c) (see Pet. Br. 25-27).

[2]Here, of course, the Board did consider "the future prospects" of the proposed holding company and subsidiary bank pursuant to 12 U.S.C. 1842(c). The Board concluded that formation of the holding company "could result in the weakening of Bank's overall financial condition" (Pet. App. 26a). That conclusion was based on the Board staff's projection of the Bank's future earnings and the holding company's debt service obligations under the financing plan (including a proposed offering of debt securities and stock) described in the application. The Board's staff concluded that the Bank's capital/asset ratio was likely to decline from 5.2 to 4.8% during the debt amortization period (A. 54). Recent studies have also stressed the substantial "affiliation risks" to which subsidiary banks may be exposed by highly leveraged parent companies. See J. Rose, *The Effect of the Bank Holding Company Movement on Bank Safety and Soundness: A Literature Review* 25-32 (Board Staff Study, April 12, 1978); M. Jessee and S. Seelig, *Bank Holding Companies and the Public Interest* 151-156 (1977) (see Pet. Br. 19).

bank," and that, although strict financial scrutiny may be appropriate when a bank receives FDIC insurance or admission into the federal reserve system, such scrutiny is not appropriate when the Board considers a holding company application (Br. 25-26). But 12 U.S.C. 1842(c), by its terms, makes the Board's consideration of a bank holding company application the occasion for examination of the financial condition of both the proposed parent and subsidiary. The Board must examine the same financial factors "now specified in the law as the basis for administrative action in connection with the admission of State banks to membership in the Federal Reserve System and the granting of deposit-insurance coverage" (H.R. Rep. No. 609, 84th Cong., 1st Sess. 15 (1955)), including the adequacy of capital and surplus relative to assets and liabilities (12 U.S.C. 329) and general financial soundness (12 U.S.C. 1816).[3]

Respondent fails to recognize that banking institutions are subject to multiple regulatory controls aimed at assuring financial soundness.[4] See *United States* v.

[3]The capital ratios applied in this case (A. 52-54) compared the bank's capital cushion to its assets (which are subject to shrinkage) and its liabilities (which may become payable on short notice). See T. Herrick, *Bank Analyst's Handbook* 197-216 (1978). These ratios assess the adequacy of the capital of the bank viewed as a going concern and are different from the standards governing the amount of paid-in capital required to commence business (12 U.S.C. 51) and the standards limiting sources of cash dividends (12 U.S.C. 60). Respondent's assertion that the Board's scrutiny of capital structure is inconsistent with the Comptroller's supervision of initial paid-in capital and dividends (Br. 11, 14, 21) is therefore incorrect.

[4]See *Fahey* v. *Mallonee*, 332 U.S. 245, 250 (1947): "Banking is one of the longest regulated and most closely supervised of public callings." It is understandable that respondent is anxious to receive the tax advantage that would result from the formation of a holding company. But the holding company would control a national bank and member of the federal reserve system, and the Board properly

Philadelphia Nat. Bank, 374 U.S. 321, 328-330 (1963), emphasizing that Congress prescribed an overlapping network of such provisions to ensure that the bank regulators have ample power to safeguard the banking system. By making full use of each opportunity for supervision, the bank regulators have achieved the congressional purpose:

> Federal supervision of banking has been called "[p]robably the outstanding example in the federal government of regulation of an entire industry through methods of supervision * * *. The system may be one of the most successful [systems of economic regulation], if not the most successful." To the efficacy of this system we may owe, in part, the virtual disappearance of bank failures from the American economic scene. [Citation and footnote omitted.]

Id. at 330.

3. Respondent further argues that the Board's longstanding policy that holding companies should be a "source of strength" to bank subsidiaries is "not even a rational goal" (Br. 11 n.6) and that Congress, in vesting the Board with discretion to grant or deny applications, did not contemplate "that the Board would have banking objections—only that it would have the anti-trust and cartel type objections in which its economic expertise is appropriately respected" (Br. 22). Respondent cites no authority that supports these assertions. The first federal statute regulating bank holding companies (the Glass-

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considers the public interest that surrounds such institutions: "National banks are not merely private moneyed institutions but agencies of the United States created under its laws to promote its fiscal policies." *First Nat. Bank* v. *Anderson*, 269 U.S. 341, 347 (1926).

Steagall Act of 1933, ch. 89, Section 19, 48 Stat. 186-187) required holding companies to maintain substantial reserves to shore up the capital of subsidiary banks. In adopting the Bank Holding Company Act of 1956, Pub. L. No. 511, 70 Stat. 133, Congress expressed its expectation that holding companies would continue to strengthen the capital of subsidiary banks. See Pet. Br. 20 n.21. When Congress amended the Bank Holding Company Act in 1966, 80 Stat. 237-238, it emphasized that the Board "must consider the financial condition * * * of the holding company," thus assuring that the goal of financial strength previously served by the "prescribed reserve" requirement of the Glass-Steagall Act would continue to be served. S. Rep. No. 1179, 89th Cong., 2d Sess. 12 (1966). This history amply supports the conclusion that "[h]olding companies are supposed to be a source of strength to subsidiary financial institutions." S. Rep. No. 95-323, 95th Cong., 1st Sess. 11 (1977).

There is consequently nothing to respondent's argument that the Board, in passing on applications, serves merely as an antitrust enforcement agency and not as a bank regulator. To be sure, the Board is required to consider competitive factors under the first sentence of 12 U.S.C. 1842(c). But that provision also contains a second sentence, which requires the Board "[i]n every case" to scrutinize the financial resources and future prospects of both the parent and the subsidiary. Financial soundness and competitive effect are independent issues, and an adverse decision with respect to either will justify denial of

the application. S. Rep. No. 1095, 84th Cong., 1st Sess. 10 (1955).[5]

4. Respondent's contention that the Board's denial was "arbitrary and capricious" (Br. 22-25) appears to be simply a restatement of respondent's principal theme. If the Court accepts our argument that the Board may consider the financial strength of the proposed holding company and its bank subsidiary, then there was nothing arbitrary or capricious about the Board's action. It was consistent with the long line of prior decisions withholding approval of holding company applications that did not provide adequate capitalization of proposed subsidiary banks (Pet. Br. 30-31). Respondent appears to concede as much (Br. 27). If respondent is willing to make provision for adequate capitalization of its proposed subsidiary in a future application, the Board stands ready to give the matter fresh consideration. Respondent may improve the present capital deficiency by a number of methods, including finding new venturers who will contribute additional equity capital at the parent company level, by selling additional bank stock, or by retaining bank earnings for a period of time and raising the capital account to an acceptable level.

The Board's disagreement with the Comptroller and the Chicago Reserve Bank is itself evidence only that reasonable people could disagree about the appropriate disposition of respondent's application; it does not show that the Board's decision was arbitrary. The Board took the views of the Comptroller and the Chicago Reserve

[5]See also *Washington Mutual Savings Bank* v. *Federal Deposit Insurance Corporation*, 482 F. 2d 459, 465 (9th Cir. 1973): "All bank supervisory agencies can reject merger applications if the banking factors are unfavorable whether or not a potential antitrust violation is present." Accord, 112 Cong. Rec. 2656 (1966) (remarks of Sen. Robertson).

Bank into consideration (Pet. App. 24a; A. 53, 56-57), but the Division of Research and Statistics, the Division of Banking Supervision and Regulation, and the Board itself had a different assessment of the situation (*ibid.*).[6] Under 12 U.S.C. 1842(b) and (c), the final decision rested with the Board.

5. *Amicus* Independent Bankers Association argues (Br. 27-31) that the Board discriminates against one-bank holding company applications and favors multi-bank applications. *Amicus* bases this argument on an erroneous statement of the facts. Between 1971 and 1976 the Board approved 745 bank holding company applications, not the 421 shown by the chart on page 28 of the brief of *amicus*. The Board approved 667 applications for one-bank holding companies (not the 141 claimed by *amicus*) and 78 applications for multi-bank holding companies (not the 311 claimed by *amicus*).[7]

The Board's 43 denials of one-bank holding company applications represent a denial rate of approximately 6% (not the 30.4% claimed by *amicus*). The Board's 15 denials of multi-bank holding company applications represent a denial rate of approximately 19% (not the 4.6% claimed

[6]The extent of disagreement should not be overstated. The Chicago Reserve Bank stated that it was probable "that capital ratios may be below Board guidelines during the [12 year] debt retirement period" (A. 21), but it felt that this factor should be disregarded in light of its optimism about future earnings and the "determination of [the] Bank's executive leadership" (A. 27). And although the Comptroller, after once recommending disapproval, changed his mind (A. 51), it is noteworthy that his bank examiner found that the Bank's capital/asset ratio had declined to approximately 5% and "strongly urged" the Bank to take "immediate steps to formulate and implement a program to fully restructure the capital funds picture to an acceptable level" (2 R. 231).

[7]The figures presented here have been certified by the Secretary of the Federal Reserve Board.

by *amicus*). One-bank holding company applications thus fare better, not worse, than multi-bank holding company applications.[8]

Amicus also argues (Br. 21-27) that the Board has issued certain "arbitrary" guidelines to determine whether holding company applications may be approved by local federal reserve banks acting under delegated authority. See 12 C.F.R. 265.2(f)(22). We would, if necessary, argue that the guidelines are quite rational,[9] but there is no need to do so. Respondent's application was not decided under delegated authority, and the proper extent of delegation therefore is irrelevant to the disposition of this case.

For the foregoing reasons, as well as those set forth in our opening brief, the judgment of the court of appeals should be reversed.

Respectfully submitted.

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[8]The lower rate of denials of one-bank holding company applications reflects the fact that such applications rarely present the competitive problems that frequently result from the formation of multi-bank holding companies.

[9]The guidelines merely allow local reserve banks to screen out applications presenting relatively simple issues that may appropriately be resolved without full Board consideration.